Cigarette Burn

Price Cut on Marlboro Upsets Rosy Notions About Tobacco Profits

Response by Philip Morris To Cheap Brands' Gains Spells Market Turmoil

The Stocks Take a Battering

4-5-93

By EBEN SHAPIRO
Staff Reporter of THE WALL STREET JOURNAL

NEW YORK – Tobacco Road is no longer paved with gold.

Philip Morris Cos., the powerful marketer that made Marlboro one of the richest and best-known brands on earth, has consistently underestimated smokers' desire for discount brands. Now, the company has set out on a painful and risky counter-strategy that is likely to trigger a price war and may permanently reduce

Philip Morris's Stock

Bargain hunters are tiptoeing toward Philip Morris stock but are waiting for it to stabilize following Friday's 23% plunge. Separately, antismoking advocates are targeting one of tobacco's last and highest-profile advertising venues: the huge billboards at baseball stadiums. Articles on pages C2 and B3.

the profitability of the world's most lucrative consumer market.

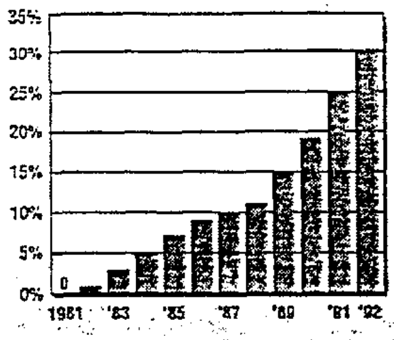
Philip Morris said Friday it plans to cut the price of its premier Marlboro brand by as much as 20% and forgo any increases on other major brands – even as it intensifies efforts in the discount business. The move will cost the company billions of dollars in profit.

For Philip Morris, the belated bid is a capitulation to a new reality: Many smokers have moved beyond the brand-loyal days when they would rather fight than switch. After spending billions of dollars over decades to forge Marlboro in the mythic images of the Old West, Philip Morris now must shoot it out on price.

The effort will roil the rest of the tobacco industry, given the company's No. 1 role, with 42.3% of the $44 billion domestic tobacco market. RJR Nabisco Holdings Corp.'s No. 2-ranked tobacco business may have to match the price cuts for its own Winston, Salem and Camel brands.

Cheap Smokes Catch Fire

Discount brands' share of total cigarette market, in unit volume.



Source: Wheat First Securities

Smaller rivals such as Brown & Williamson Tobacco Corp., a division of B.A.T Industries PLC, and Liggett Group Inc. could be even more harshly affected.

"The game is over," contends Gary D. Black of Sanford C. Bernstein & Co., one of the few Wall Street analysts who have been bearish on Philip Morris. "The No. 1 player is saying that prices were too high." With people kicking the habit, he warns: "The risk is that everybody is going to be throwing gobs of money at a shrinking base of smokers."

Changing Habits

For makers of consumer goods, the action is a milestone in marketing, the most dramatic evidence yet of a fundamental shift in consumer buying habits. More and more, shoppers are bypassing household names for the cheaper, no-name products one shelf over. "This shows that even the biggest and strongest brands in the world are vulnerable," says marketing consultant Jack Trout. "Marlboro Country can only come at a certain price."

Philip Morris says its counterattack will result in a 40% decline in pretax profit in its U.S. tobacco business this year – a drop of about $2 billion. That apparently marks the first decrease in U.S. tobacco profits in the company's history. The U.S. unit is the company's single largest profit contributor, providing a huge $5.2 billion in pretax earnings last year and almost half of total earnings.

So far at least, Philip Morris's move affects only its U.S. business. The company's newly issued 1992 annual report says that "our world-wide tobacco business has greater opportunities now than ever before." And Philip Morris said Friday that investors are "overlooking the growth and improved profitability of our other businesses."

Nonetheless, Wall Street retaliated against Philip Morris's announcement Friday. Traders dumped more than 34 million shares, knocking nearly $13 billion in a single day off the company's already depressed stock-market value. That marked a 23% one-day plunge and contributed to a 68.63-point drop in the Dow Jones Industrial Average Friday. It left institutional investors in the widely held equity grappling with whether to get out or hang tough. It also prompted the quick filing of at least three shareholder lawsuits accusing the company of misleading investors.

Wall Street also drubbed other tobacco

2072380211

Cigarette Burn: Philip Morris Price Cut on Marlboro Jolts Industry and Upsets Rosy Profit Assumptions

Continued From First Page

stocks Friday, sending share prices down in double-digit percentages for RJR, Liggett owner Brooke Group Ltd., American Brands Inc. and Loews Corp., which owns Lorillard Inc.

At Philip Morris, which supplies the world with dozens of other household brands including Velveeta cheese, Oscar Mayer bacon, Post Raisin Bran and Miller Lite, the new effort puts considerable pressure on Chief Executive Officer Michael A. Miles and on William I. Campbell, head of the tobacco unit.

Mr. Miles, a much-praised food marketer, emerged from the company's Kraft General Foods side in September 1991 to become the first nontobacco executive to be named its chairman and CEO. He had already been put on the defensive by an earlier 20%-plus drop in the stock price since last fall. Mr. Miles declined to be interviewed, leaving Mr. Campbell, president and chief executive of the Philip Morris USA, to face analysts and handle the press.

Wall Street didn't greet him all that kindly. "Bill Campbell has done a shoddy job of keeping abreast of the market," charged Ronald Morrow, a Smith Barney, Harris Upham & Co. analyst who had been bullish on Philip Morris until the Friday morning announcement. "If Marlboro doesn't regain share, Bill is going to be looking for work," he predicted.

Misjudging the Market

For Mr. Campbell, it was the second time this year that he has publicly admitted the company misjudged the market. In January, he told analysts he was "surprised" by the rapid growth in cheap cigarettes last fall. But he played down the significance of a 5.6% drop in Marlboro shipments for 1992, the steepest slide in the brand's history. He said growth was slowing in the discount market.

On Friday, he admitted he was wrong and disclosed that, in the first quarter, Marlboro shipments were down 8% from a year earlier. "The news has gone from good to bad in a very short time," he told fund managers. Later in the day, he added: "This market has moved very quickly. We don't see it today the way we saw it in January."

William I. Campbell

Philip Morris's inventory began building to dangerous levels in the wholesale pipeline late last year, as the company encouraged distributors to load up on Marlboro to avoid a Jan. 1 price increase. The backlog worsened in January, when Philip Morris pushed distributors to take on new packs of *Marlboros emblazoned*

Then in March, it tried to spur volume again by announcing a small price increase for April, hoping wholesalers would rush to put in new orders before the higher prices kicked in.

But with warehouses already brimming, Philip Morris found far fewer takers than usual. "It was a smack of reality," says Steven Rosenthal, president of Bonanza Trading Associates, a New York distributor. His Bronx warehouse is still packed with more than twice its usual inventory of Marlboros. (It is unclear if or how wholesalers will be reimbursed for the lower value of their inventories.)

Banking on the Future

Philip Morris maintains it has little choice but to launch the new offensive and contends the strategy, though painful in the short term, will ultimately lead to accelerated growth. Some marketing experts agree.

"It is the job of market leaders to create profitability in the industry," says Gary Stibel, founder of New England Consulting Group, a marketing-consulting firm. Adds Leo J. Shapiro, a marketing expert in Chicago: "This is a good investment for Philip Morris. It behooves a major player to bring up its market share."

Discount brands now make up 36% of the market in unit terms, by Philip Morris's latest calculations, and are expected by some tobacco analysts to hit 50% by decade's end. These brands typically bring in only a nickel a pack in profit, compared with about 55 cents a pack for Marlboros. They cut $1 billion from industry profits last year alone. Once Philip Morris cuts Marlboro's price, analysts fret, it may never head back up again. On Friday, analysts slashed earnings estimates for the company by 20% to 30% for 1994, when the new plan is supposed to be producing results.

But Mr. Campbell contends: "When we make Marlboro more affordable, it will grow."

The Marlboro marketers began trying out the price-cut strategy in a month-long test last December. In Portland, Ore., they shaved 40 cents from the price, to below $2 a pack, and saw Marlboro's market share quickly rise four percentage points. That was encouraging, given the two-point decline in Marlboro's domestic share, to 22.2% last year.

In February, marketers were further convinced a cut was needed when they attended a gathering of Philip Morris brass in Scottsdale, Ariz. There, at myriad Circle K convenience stores, fluttering banners beckoned to patrons stocking up on beer and Twinkies to "Move to Austin," the stores' own private-label smokes — at just 89 cents a pack. "You couldn't get out of the hotel driveway without running into Austins," Mr. Campbell says.

Austins have become one of the best-selling brands at Circle K in just a few

was the identity of Austin's maker: Forsyth Tobacco Co. — owned by RJR, Philip Morris's biggest rival.

RJR is one big reason the Marlboro man has been forced into this shootout. While Philip Morris is the undisputed leader in full-price cigarettes and dwarfs RJR's 29% market share, RJR has moved out ahead in discount brands.

The foes have long taken sharply different approaches. RJR's R.J. Reynolds, based in the heart of tobacco country in Winston-Salem, N.C., relies on its sales force to push volume through retailers and wholesalers. Philip Morris, with headquarters on Park Avenue in New York, is known for marketing prowess and an ability to cultivate a desirable image for its brands. This raises the risk that for some smokers, the cut in price could sully the brand's mystique. The company had always held Marlboro above the fray, even as RJR used heavy discounts for its Camel brand to pick up new smokers last year.

When the low-priced cigarettes first emerged a little more than a decade ago, both companies all but ignored them. At the time, Liggett & Myers resorted to private-label brands in a nearly desperate effort to stay in business as sales of its Lark and L&M lines faltered. It was able to charge about a dollar a pack by throwing out the huge costs of advertising and promotion.

Michael A. Miles

The larger rivals scoffed. They had spent billions linking cigarette brands to sexy imagery and illusions of the high life.

But Philip Morris and RJR managed to drive away an increasing number of customers by routinely raising prices semiannually by a combined 10% or more. Cigarette makers blame taxes for the steep increases, but data provided by the industry's own lobby, the Tobacco Institute, show they aren't the whole picture: from 1980 to 1991, taxes doubled to 45 cents a pack while prices nearly tripled to an average of $1.74 a pack. They rose to the $2 mark last year.

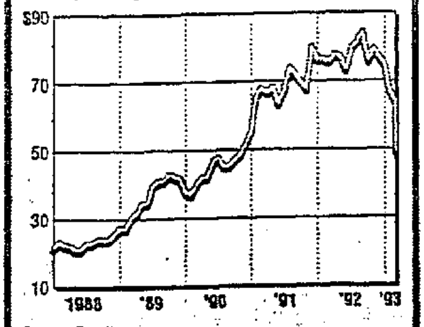
'Dance of Death'

Discount brands, starting at zero in 1981, passed 7% of all cigarettes sold in 1985, doubled their share in the next four years, and have since more than doubled again. Much of the later growth, however, reflects an entry into the discount market by Philip Morris and RJR themselves—even though that has meant sacrificing high profit margins and hurting their own full-price brands.

"They are in a mutual dance of death that is strangling their full-price busi-

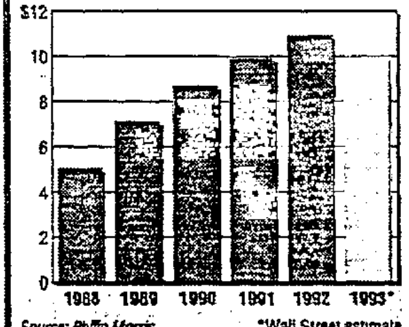
Price Erosion Hurts Philip Morris

The Stock Falls...
Monthly closing stock prices



Source: Baseline

And Profit Growth Slows
Total operating income, in billions of dollars



Source: Philip Morris *Wall Street estimate

try consultant, says of Philip Morris and RJR.

Mr. Campbell acknowledges that Philip Morris has been "a reluctant competitor" in discount cigarettes because of the effect on premium brands. "For us it's always been a kind of damned if you do, damned if you don't situation," he says.

At the low end, RJR has been the more aggressive rival, seizing control of one-third of the discount business last year. Philip Morris had a 27% share of it. RJR stepped up its presence in the pennies-a-pack market in 1987, when it created Forsyth Tobacco to make a house brand of cigarettes for Kmart Corp.

Forsyth operates out of the same building in downtown Winston-Salem that houses RJR's regular staff and uses the same factories.

RJR's centerpiece in discounts is the bargain-basement Monarch brand. But it has also gained share – though little profit – by accelerating the move into a portfolio of customized, under-a-buck brands that it makes for even the smallest store chains.

As part of its pursuit of the discount business, RJR last year began bypassing traditional tobacco distributors and going straight to convenience-store chains and gas stations, offering to create house brands for any willing customer. While filling up at one of the 800 gas stations owned by BP Oil Co., for example, smokers can pick up a pack of Highway cigarettes for as little as 69 cents a pack, made expressly for the British Petroleum Co. subsidiary by RJR's Forsyth.

Wild for Jacks

A few months ago, the 165-outlet Sheetz Convenience stores chain began selling its own line of cigarettes, Jacks, in a simple white pack emblazoned with the face of a playing card. Made by RJR and selling at 99 cents a pack, Jacks were an immediate hit and now account for half the Altoona, Pa., chain's cigarette business. Jacks even outsells RJR's own Camel and Winston lines at Sheetz stores.

One small consolation for RJR: Jacks also outsells Marlboro there.

Philip Morris reluctantly decided to grab a piece of this action last year, even though RJR isn't exactly getting rich on it: Last year RJR's sales rose 5% to $6.16 billion, but its operating profit dropped 5% to $2.11 billion. Until last year, Philip Morris had been cautious, selling the $1.50-a-pack Cambridge brand but mostly avoiding the 99-cent wars. Yet retailers say that over last summer, Philip Morris made an all-out assault on the discount category, pursuing customers like QuikTrip Corp., based in Tulsa, Okla.

The bestselling cigarette at QuikTrip's convenience stores isn't heavily promoted Marlboros but the chain's own cut-rate Bronson line. It fares so well that Philip Morris offered special discounts on a variety of brands and other incentives to persuade QuikTrip to let it manufacture the brand. QuikTrip dumped Bronson's maker of nine years, Liggett Group.

"Philip Morris came to us with a package that was pretty compelling," says Wyatt Phillips, QuikTrip's vice president, marketing.

Narrow Margins

Now, Philip Morris says it will "intensify its efforts to obtain market share in all industry segments and will take prompt action to expand the distribution of its discount brands." It pledges to "achieve a leading share in discounts."

The company may get some help from smokers. Last week, the Centers for Disease Control and Prevention in Atlanta said the rate of smoking in the U.S. increased slightly in 1991, the first rise after declining for 25 years. The CDC said it was partly a result of discount cigarettes making smoking affordable.

After gaining a combined 60% of the discount business, Philip Morris and RJR have set about trying to raise prices. They apparently had hoped both to increase the profits on the generics – to perhaps 15 cents a pack from a nickel – and to push more smokers back to full-price brands. Since August, in an apparent coincidence, both tobacco giants have raised the wholesale price of their cheapest smokes four times for a total of 40%, analysts say.

It hasn't worked. The chain stores are fuming. "It irritates me to no end," says Louie Sheetz, marketing vice president of the convenience-store chain. He vows to switch to a smaller, hungrier supplier if RJR tries to force through another increase on his store brand. "We are going to have Jacks at a low price forever," he declares.

Philip Morris's Mr. Campbell concedes price increases on the private labels haven't stuck, for which he blames a new round of reductions by RJR. But he all but disavows the company's statement that it will push harder in discounts, focusing instead on his plans for Marlboro. The new strategy again aims for narrowing the price gap between discount brands and Marlboro – but this time by cutting prices on the high end.

The company insists the Marlboro move isn't an outright price cut. Philip Morris will use coupons and price cuts in some markets to whack Marlboro's price tag by 40 cents a pack. It will also lure smokers with special promotions: Buy three packs, get two free. For its other major brands, such as Virginia Slims, Benson & Hedges and Merit, it says it will forgo "any further price increases . . . for the foreseeable future."

The result of all this, the company contends, ultimately will be an upturn in Marlboro sales, market share and profit. But RJR has already vowed to compete aggressively, and it and lesser rivals could keep prices so low in their discount labels that Marlboros could remain unattractive to many smokers.

Other threats persist. For one thing, there is the continuing possibility that tobacco companies could someday be held liable for smoking-related illnesses. A more pressing concern to the industry is the Clinton administration's plan to raise the excise tax on cigarettes from the current 24 cents a pack could wipe out the 40-cent break that Philip Morris wants to deliver on Marlboro. Even though the tax would go on private labels, too, it could push Marlboro's price back over $2, sending more smokers in search of cheap relief.

Indeed, tobacco experts say the most likely consequence of the new push is simply lower profits and, perhaps, permanently lower prices on Philip Morris's franchise brand. "It is risky," says Mr. Rosenthal of Bonanza Trading. "It may create permanent and insidious downward pricing pressuring on their most profitable brands."

It isn't clear just how low Marlboros and other mainstay brands will have to go to lure smokers back to the full-price fold. The answer may be alarming given avid smokers like Douglas Crandall. A railroad machine operator and lifelong smoker in Barstow, Ill., he started out puffing Marlboros years ago in the Army, back when he could buy them for just 28 cents a pack at the PX. He got out of the service and later switched to Camels.

But nowadays he is content to smoke three packs a day of G.P.C. Approved, a buck-a-pack brand made by Brown & Williamson. Forget about brand loyalty and image. "A cigarette is a cigarette," Mr. Crandall says.

2072380213